

- (3) Illustrations.
- (e) Certain property transactions.
  - (1) In general.
  - (i) Inclusion of FPHC income.
  - (ii) Dual character property.
- (2) Property that gives rise to certain income.
  - (1) In general.
  - (ii) Exception.
- (3) Property that does not give rise to income.
- (4) Classification of gain or loss from the disposition of a debt instrument or on a deferred payment sale.
  - (i) Gain.
  - (ii) Loss.
- (5) Classification of options and other rights to acquire or transfer property.
- (6) Classification of certain interests in pass-through entities.
- [Reserved]
- (f) Commodities transactions.
  - (1) In general.
  - (2) Definitions.
    - (i) Commodity.
    - (ii) Commodities transaction.
  - (3) Definition of the term "qualified active sales".
    - (i) In general.
    - (ii) Sale of commodities.
    - (iii) Active conduct of a commodities business.
    - (iv) Definition of the term "substantially all."
  - (4) Definition of the term "qualified hedging transaction".
    - (g) Foreign currency gain.
      - (1) In general.
      - (2) Exceptions.
    - (i) Qualified business units using the dollar approximate separate transactions method.
    - (ii) Tracing to exclude foreign currency gain or loss from qualified business and hedging transactions.
    - (iii) Election out of tracing.
  - (3) Definition of the term "qualified business transaction".
    - (i) In general.
    - (ii) Specific section 988 transactions attributable to the sale of goods or services.
      - (A) Acquisition of debt instruments.
      - (B) Becoming the obligor under debt instruments.
      - (C) Accrual of any item of gross income.
      - (D) Accrual of any item of expense.
      - (E) Entering into forward contracts, futures contracts, options, and similar instruments.
      - (F) Disposition of nonfunctional currency.
  - (4) Definition of the term "qualified hedging transaction".
    - (i) In general.
    - (ii) Change in purpose of hedging transaction.
    - (5) Election out of tracing.
      - (i) In general.
      - (ii) Exception.

- (iii) Procedure.
  - (A) In general.
  - (B) Time and manner.
  - (C) Termination.
  - (h) Income equivalent to interest.
    - (1) In general.
- (2) Illustrations.
- (3) Income equivalent to interest from factoring.
  - (i) General rule.
  - (ii) Exceptions.
- (iii) Factored receivable.
- (iv) Illustrations.
- (4) Determination of sales income.
- (5) Receivables arising from performance of services.

[T.D. 8216, 53 FR 27491, July 21, 1988. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

**§4.954-1 Foreign base company income; taxable years beginning after December 31, 1986.**

(a) *In general*—(1) *Purpose and scope.* Section 954 (b) through (g) and §§1.954-1T and 1.954-2T provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952 and the regulations thereunder. Subpart F income is included in the gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and the regulations thereunder, and thus is subject to current taxation under section 1 or 11 of the Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957 and the regulations thereunder.

(2) *Gross foreign base company income.* For taxable years of a controlled foreign corporation beginning after December 31, 1986, the gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income:

- (i) Its foreign personal holding company income, as defined in section 954(c) and §1.954-2T.
- (ii) Its foreign base company sales income, as defined in section 954(d) and the regulations thereunder,

(iii) Its foreign base company services income, as defined in section 954(e) and the regulations thereunder,

(iv) Its foreign base company shipping income, as defined in section 954(f) and the regulations thereunder, and

(v) Its foreign base company oil related income, as defined in section 954(g) and the regulations thereunder.

(3) *Adjusted gross foreign base company income.* The term “adjusted gross foreign base company income” means the gross foreign base company income of a controlled foreign corporation as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section.

(4) *Net foreign base company income.* The term “net foreign base company income” means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions properly allocable to such income under the rules of section 954(b)(5) and paragraph (c) of this section. In computing net foreign base company income, foreign personal holding company income is reduced (but not below zero) by related person interest expense before allocating and apportioning other expenses in accordance with the rules of paragraph (c) of this section and § 1.904(d)-5(c)(2).

(5) *Adjusted net foreign base company income.* The term “adjusted net foreign base company income” means the net foreign base company income of a controlled foreign corporation reduced by any items of net foreign base company income for which the high tax exception of paragraph (d) of this section is elected. The term “foreign base company income” as used in the Code and elsewhere in the regulations generally means adjusted net foreign base company income.

(6) *Insurance income definitions.* The term “gross insurance income” includes any item of gross income taken into account in determining insurance income under section 953 and the regulations thereunder. The term “adjusted gross insurance income” means gross insurance income as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section. The term “net insurance income” means adjusted gross insurance income reduced

under section 953 and the regulations thereunder so as to take into account deductions properly allocable or apportionable to such income. The term “adjusted net insurance income” means net insurance income reduced by any items of net insurance income for which the high tax exception of paragraph (d) of this section is elected.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income. Thus, they are not included in the gross foreign base company income or gross insurance income of the controlled foreign corporation in computing adjusted gross foreign base company income or adjusted gross insurance income (for purposes of applying the de minimis and full inclusion tests of paragraph (b) of this section).

(8) *Illustration.* The order of computation is illustrated by the following example. Computations in this paragraph (a)(8) and in paragraph (b)(5) of this section involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section.

*Example.* (i) *Gross income.* CFC, a controlled foreign corporation, has gross income of \$1000 for the current taxable year. Of that \$1000 of income, \$100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954-2T(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), and is not excluded from foreign personal holding company income under any provision of section 954(c) and § 1.954-2T. Another \$50 is foreign base company sales income under section 954(d) and the regulations thereunder. The remaining \$850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g), or 953 and the regulations thereunder, and is foreign source general limitation income described in section 904(d)(1)(I) and the regulations thereunder.

(ii) *Expenses.* CFC has expenses for the current taxable year of \$500. Of that \$500, \$8 is

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from interest paid to a related person and is allocable to foreign personal holding company income along with \$2 of other expense. Another \$20 of expense is allocable to foreign base company sales. The remaining \$470 of expense is allocable to income other than foreign base company income or insurance income.

(iii) *Earnings and deficits.* *CFC* has earnings and profits for the current taxable year of \$500. In the prior taxable year, *CFC* had losses with respect to income other than gross foreign base company income or gross insurance income. By reason of the limitation provided under section 952(c)(1)(A) and the regulations thereunder, those losses reduced the subpart F income (consisting entirely of foreign source general limitation income) of *CFC* by \$600 for the prior taxable year.

(iv) *Taxes.* Foreign tax of \$30 is considered imposed on the interest income under the rules of section 954(b)(4) and paragraph (d) of this section. Foreign tax of \$14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4) and paragraph (d) of this section. Foreign tax of \$177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have \$500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows. The following steps do not illustrate the computation of the subpart F income of a controlled foreign corporation that has income from a trade or service receivable treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

*Step 1—Determine gross income:*

(1) Gross income .....\$1000

*Step 2—Determine gross foreign base company income and gross insurance income:*

(2) Interest income included in foreign personal holding company income under section 954 (c) .....100  
 (3) Foreign base company sales income under section 954(d) .....50  
 (4) Total gross foreign base company income gross insurance income as defined in sections 954(c), (d), (e), (f) and (g) and 953 and the regulations thereunder (line (3) plus line (4)) .....150

*Step 3—Determine adjusted gross foreign base company income and adjusted gross insurance income:*

(5) Five percent of gross income (.05 × line (1)) .....50  
 (6) Seventy percent of gross income (.70 × line (1)) .....700  
 (7) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the de minimis test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or \$1,000,000) .....150  
 (8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6)) .....150

*Step 4—Compute net foreign base company income:*

(9) Related person interest expense and other expense allocable and apportionable to foreign personal holding company income .....10  
 (10) Deductions allocable and apportionable to foreign base company sales income .....20  
 (11) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (2) or line (7), reduced (but not below zero) by line (9)) .....90  
 (12) Foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (3) or line (7), reduced (but not below zero) by line (10)) .....30  
 (13) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (11) plus line (12)) .....120

*Step 5—Compute net insurance income:*

(14) Net insurance income under section 953 and the regulations thereunder .....0

*Step 6—Compute adjusted net foreign base company income:*

(15) Foreign tax imposed on foreign personal holding company income (as determined under paragraph (d)) .....30  
 (16) Foreign tax imposed on foreign base company sales income (as determined under paragraph (d)) .....14  
 (17) Ninety percent of the maximum U.S. corporate tax rate .....30.6  
 (18) Effective rate of foreign tax imposed on foreign personal holding

company income (interest) under section 954(b)(4) and paragraph (d) (line (15) divided by line (11)) .....	33
(19) Effective rate of foreign tax imposed on \$40 of foreign base company sales income under section 954(b)(4) and paragraph (d) (line (16) divided by line (12)) .....	47
(20) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (11) if line (18) is greater than line (17)) .....	90
(21) Foreign base company sales income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (12) if line (19) is greater than line (17)) .....	30
(22) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (13), reduced by the sum of line (20) and line (21)) .....	0

*Step 7—Compute adjusted net insurance income:*

(23) Adjusted net insurance income.....	0
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*Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):*

(24) Earnings and profits for the current year .....	500
(25) The excess in earnings and profits over subpart F income subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (24) over the sum of lines (22) and (23); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year) .....	500
(26) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder .....	600
(27) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (22), line (23), and the lesser of line (25) or line (26)) .....	500

(b) *Computation of adjusted gross foreign base company income and adjusted gross insurance income*—(1) *De minimis rule, etc.*—(i) *In general.* If the de minimis rule of paragraph (b)(1)(ii) of this section applies, then adjusted gross foreign base company income and adjusted gross insurance income are each equal to zero. If the full inclusion rule of paragraph (b)(1)(iii) of this section

applies, then adjusted gross foreign base company income consists of all items of gross income of the controlled foreign corporation other than gross insurance income, and adjusted gross insurance income consists of all items of gross insurance income. Otherwise, the adjusted gross foreign base company income of a controlled foreign corporation consists of the gross foreign base company income of the controlled foreign corporation, and the adjusted gross insurance income of a controlled foreign corporation consists of the gross insurance income of the controlled foreign corporation.

(ii) *Five percent de minimis test*—(A) *In general.* The de minimis rule of this paragraph (b)(1)(ii) applies if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—

- (1) 5 percent of gross income, or
- (2) \$1,000,000.

Controlled foreign corporations having a functional currency other than the U.S. dollar shall translate the \$1,000,000 threshold using the exchange rate provided under section 989(b)(3) and the regulations thereunder for amounts included in income under section 951(a).

(B) *Coordination with section 864(d).* Gross foreign base company income or gross insurance income of a controlled foreign corporation always includes items of income from trade or service receivables described in section 864(d)(1) or (6), even if the de minimis rule of this paragraph (b)(1)(ii) is otherwise applicable. In that case, adjusted gross foreign base company income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross foreign base company income, and adjusted gross insurance income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross insurance income.

(iii) *Seventy percent full inclusion test.* The full inclusion rule of this paragraph (b)(1)(iii) applies if the sum of the foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income.

(2) *Character of items of gross income included in adjusted gross foreign base company income.* The items of gross income included in the adjusted gross foreign base company income of a controlled foreign corporation retain their character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. Items of gross income included in adjusted gross income because the full inclusion test of paragraph (b)(1)(iii) of this section is met are termed “full inclusion foreign base company income,” and constitute a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Items of gross foreign base company income or gross insurance income that are excluded from adjusted foreign base company income or adjusted gross insurance income because the de minimis test of paragraph (b)(1)(ii) of this section is met are potentially subject to recharacterization as adjusted net foreign base company income or adjusted net insurance income (or other categories of income included in the computation of subpart F income under section 952 and the regulations thereunder) for the taxable year under the rules of section 952(c). Items of full inclusion foreign base company income that are included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(iii) of this section is met, and are included in subpart F income under section 952 and the regulations thereunder, do not reduce amounts that, under section 952(c), are subject to recharacterization in later years on account of deficits in prior years.

(4) *Anti-abuse rule—(i) In general.* For purposes of applying the de minimis and full inclusion tests of paragraph (b)(1) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if one principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to avoid

the application of the de minimis or full inclusion requirements of paragraph (b)(1) of this section. For purposes of this paragraph (b), a principal purpose need not be the purpose of first importance.

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to avoid the effect of the de minimis and full inclusion requirements of paragraph (b)(1) of this section if the corporations are related persons as defined in subdivision (iii) of this paragraph (b)(4) and the corporations are described in subdivision (A), (B), or (C). This presumption may be rebutted by proof to the contrary.

(A) The activities now carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were carried on, or assets that were previously held by a single controlled foreign corporation, and the United States shareholders of the controlled foreign corporations or related persons (as determined under subdivision (iii) of this paragraph (b)(4)) are substantially the same as the United States shareholders of the one controlled foreign corporation in that prior taxable year. A presumption made in connection with the requirements of this subdivision (A) of paragraph (b)(4)(ii) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of §1.367(a)-6T(g) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership (as defined in section 7701(a)(2) and §301.7701-3) that is a related person (as defined in subdivision (iii) of this paragraph (b)(4)) with respect to each such controlled foreign corporation.

(C) The activities carried on by the controlled foreign corporations would constitute a single branch operation under §1.367(a)-6T(g)(2) if carried on directly by the United States person.

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b).

In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). In determining for purposes of this paragraph (b) whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Illustration.* The following example illustrates the application of this paragraph (b)(4).

*Example.* USP is the sole United States shareholder of three controlled foreign corporations: *CFC1*, *CFC2* and *CFC3*. The three controlled foreign corporations all have the same taxable year. The three controlled foreign corporations are partners in *FP*, a foreign entity classified as a partnership under section 7701(a)(2) and § 301.7701-3 of the regulations. For their current taxable years, each of the controlled foreign corporations derives all of its income other than foreign base company income from activities conducted through *FP*, and its foreign base company income from activities conducted both jointly through *FP* and separately without *FP*. Based on the facts in the table below, for their current taxable years, the foreign base company income derived by each controlled foreign corporation, including income derived from *FP*, is less than five percent of the gross income of each controlled foreign corporation and is less than \$1,000,000:

	CFC1	CFC2	CFC3
Gross income .....	\$4,000,000	\$8,000,000	\$12,000,000
Five percent of gross income .....	200,000	400,000	600,000
Foreign base company income .....	199,000	398,000	597,000

Thus, without the application of the anti-abuse rule of this subparagraph (5), each controlled foreign corporation would be treated as having no foreign base company income after the application of the de minimis rule of section 954(b)(3)(A) and § 1.954-1T(b)(1).

However, under these facts the requirements of subdivision (i) of this paragraph (b)(4) are presumed to be met. The sum of the foreign base company income of the controlled foreign corporations is \$1,194,000. Thus, the amount of adjusted gross foreign base company income will not be less than the amount of gross foreign base company

income by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(5) *Illustration.* The following example illustrates computations required by sections 952 and 954 and this § 1.954-1T if the full inclusion test of paragraph (b)(1)(iii) is met (see paragraph (a)(8) for an example illustrating computations required if the de minimis test of paragraph (b)(1)(ii) is met):

*Example.* (i) *Gross Income.* *CFC*, a controlled foreign corporation, has gross income of \$1,000 for the current taxable year. Of that \$1,000 of income, \$720 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954-2T(b)(ii), is not income from trade or service receivables described in section 864(d) (1) or (6), and is not excluded from foreign personal holding company income under any provisions of section 954(c) and § 1.954-2T. The remaining \$280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g) or 953 and the regulations thereunder, and is foreign source general limitation income for purposes of section 904(d)(1)(I).

(ii) *Expenses.* *CFC* has expenses for the current taxable year of \$650. Of that \$650, \$350 is from interest paid to related persons that is allocable to foreign personal holding company income along with \$50 of other expense. The remaining \$250 of expense is allocable to services income other than foreign base company income or insurance income.

(iii) *Earnings and deficits.* *CFC* has earnings and profits for the current taxable year of \$350. In the prior taxable year, *CFC* had losses with respect to income other than foreign base company income or insurance income. By reason of the limitation provided under section 952(c)(1)(A) and the regulations thereunder, those losses reduced the subpart F income of *CFC* (consisting entirely of foreign source general limitation income) by \$600 for the prior taxable year.

(iv) *Taxes.* A foreign tax of \$120 is considered imposed on the \$720 of interest income under the rules of section 954(b)(4) and paragraph (d) of this section, and a foreign tax of \$2 is considered imposed on the services income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have \$350 of subpart F income as defined in section 952(a) determined as follows:

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## Step 1—Determine gross income:

(1) Gross income .....\$1000

## Step 2—Compute gross foreign base company income and gross insurance income:

(2) Gross foreign base company income and insurance income as defined in sections 954(c), (d), (e), (f), (g) and 953 and the regulations thereunder (interest income) .....720

## Step 3—Compute adjusted gross foreign base company income:

(3) Seventy percent of gross income (.70 × line (1)) .....700  
(4) Adjusted gross foreign base company income or insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3)) .....1000  
(5) Full inclusion foreign base company income under paragraph (a)(2)(vi) (line (4) minus line (2)) .....280

## Step 4—Compute net foreign base company income:

(6) Related person interest expense and other deductions allocable and apportionable to foreign personal holding company income under section 954(b)(5) and paragraph (c) .....400  
(7) Deductions allocable and apportionable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c) .....250  
(8) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced (but not below zero) by line (6)) .....320  
(9) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) paragraph (c) of this section (line (5) reduced (but not below zero) by line (7)) .....30  
(10) Total gross foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (8) plus line (9)) .....350

## Step 5—Compute net insurance income:

(11) Net insurance income under section 953 and the regulations thereunder .....0

## Step 6—Compute adjusted net foreign base company income:

(12) Foreign tax imposed on foreign personal holding company income

(interest) .....120

(13) Foreign tax imposed on full inclusion foreign base company income .....2

(14) Ninety percent of the maximum U.S. corporate tax rate .....30.6

(15) Effective rate of foreign tax imposed on \$320 of foreign personal holding company income under section 954(b)(4) and paragraph (d) (line (12) divided by line (8)) .....38

(16) Effective rate of foreign tax imposed of \$30 of full inclusion foreign base company income under section 954(b)(4) and paragraph (d) (line (13) divided by line (9)) .....7

(17) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (8) if line (15) is greater than line (14)) .....320

(18) Full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (9) if line (16) is greater than line (14)) .....0

(19) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (10), reduced by the sum of line (17) and line (18)) .....30

## Step 7—Compute adjusted net insurance income:

(20) Adjusted net insurance income .....0

## Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):

(21) Earnings and profits for the current year .....350

(22) The excess in earnings and profits over subpart F income, which is subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (21) over the sum of line (19) and line (20)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year .....320

(23) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder .....600

(24) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (19) and line (20) plus the lesser of line (22) or line (23)) .....350

(25) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years

under section 952(c) (excess of line (23) over line (22)) .....280

(c) *Computation of net foreign base company income.* The net foreign base company income of a controlled foreign corporation is computed by reducing (but not below zero) the amount of gross income in each of the categories of adjusted gross foreign base company income described in paragraph (b)(2) of this section, so as to take into account deductions allocable and apportionable to such income. For purposes of section 954 and this section, expenses must be allocated and apportioned consistent with the allocation and apportionment of expenses for purposes of section 904(d). For purposes of this § 1.954-1T, an item of net foreign base company income must be categorized according to the category of adjusted gross foreign base company income from which it is derived. Thus, an item of net foreign base company income must be categorized as a net item of—

- (1) Foreign personal holding company income,
- (2) Foreign base company sales income,
- (3) Foreign base company services income,
- (4) Foreign base company shipping income,
- (5) Foreign base company oil related income, or
- (6) Full inclusion foreign base company income.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income—(1) Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any item of such income (other than foreign base company oil related income as defined in section 954(g)) subject to the high tax exception provided by section 954(b)(4) and this paragraph (d). An item of income is subject to the high tax exception only if—

- (i) It is established that the income was subject to creditable income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 or 15 for the

taxable year of the controlled foreign corporation; and

- (ii) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income.

See paragraph (d)(4) of this section for the definition of the term “item of income.” For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see § 904-1.4(c)(1).

(2) *Effective rate at which taxes are imposed.* For purposes of this paragraph (d), the effective rate at which taxes are imposed on an item of income is—

- (i) The amount of income taxes paid or accrued (or deemed paid or accrued) with respect to the item of income, determined under paragraph (d)(3) of this section, divided by

(ii) The item of net foreign base company income or net insurance income, determined under paragraph (d)(4) of this section (including the appropriate amount of income taxes referred to in subdivision (i) of this paragraph (d)(2), immediately above).

(3) *Taxes paid or accrued with respect to an item of income—(i) Income other than passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of income (other than an item of foreign personal holding company income that is passive income) for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a U.S. shareholder under section 951(a)(1)(A). For this purpose, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a).

(ii) *Passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of foreign personal holding company income that is passive income for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes paid or accrued or deemed paid by the foreign corporation



that would be taken into account for purposes of applying the provisions of §1.904-4(c) with respect to that item of income.

(4) *Item of income*—(i) *Income other than passive foreign personal holding company income.* The high tax exception applies (when elected) to all income that constitutes a single item under this paragraph (d)(4). A single item of net foreign base company income or net insurance income is an amount of net foreign base company income (other than foreign personal holding company income that is passive income) or net insurance income that:

(A) Falls within a single category of net foreign base company income, as defined in paragraph (c) of this section, or net insurance income, and

(B) Also falls within a single separate limitation category for purposes of sections 904(d) and 960 and the regulations thereunder.

(ii) *Passive foreign personal holding company income*—(A) *In general.* For purposes of this paragraph (d) a single item of net foreign personal holding company income that is passive income is an amount of such income that falls within a single group of passive income under the grouping rules of §1.904-4(c) (3), (4), and (5).

(B) *Consistency rule.* An election to exclude income from subpart F must be consistently made with respect to all items of passive foreign personal holding company income eligible to be excluded. Thus, high-taxed passive foreign personal holding company income of a controlled foreign corporation must be excluded in its entirety, or remain subject to subpart F.

(5) *Procedure.* The election provided by this paragraph (d) must be made—

(i) By controlling United States shareholders, as defined in §1.964-1(c)(5), by attaching a statement to such effect with their original or amended income tax returns, and including any additional information required by subsequent administrative pronouncements, or

(ii) In such other manner as may be prescribed in subsequent administrative pronouncements.

An election made under the procedure provided by this paragraph (d)(5) is binding on all United States share-

holders of the controlled foreign corporation.

(6) *Illustrations.* The rules of this paragraph (d) are illustrated by the following examples.

*Example 1.* (i) *Items of income.* During its 1987 taxable year, controlled foreign corporation CFC receives from outside its country of operation portfolio dividend income of \$100 and interest income of \$100 (consisting of a gross payment of \$150 reduced by a third-country withholding tax of \$50). For purposes of illustration, assume that the CFC incurs no expenses. None of the income is taxed in CFC's country of operation. The dividend income was not subject to their-country withholding taxes. The interest income was subject to withholding taxes equal to \$50, and is therefore high withholding tax interest for purposes of section 960 (pursuant to the operation of section 904). The dividend income is passive income for purposes of section 960. Accordingly, pursuant to paragraph (d)(4) of this section, CFC has two items of income: (1) \$100 of FPHC/passive income (the dividends) and (2) \$100 of FPHC/high withholding tax income (the interest). The election under paragraph (d)(5) of this section to exclude high-taxed income from the operation of subpart F is potentially applicable to each such item in its entirety.

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to item (1). Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F under the rules of this paragraph (d). Foreign tax of \$50 would be deemed paid under section 960 with respect to item (2). Therefore, the effective rate of foreign tax is 33 percent (\$50 of creditable taxes paid, divided by \$150, consisting of the item of net foreign base company income (\$100) plus creditable taxes paid thereon (\$50). The highest rate of tax specified in section 11 for the 1987 taxable year is 34 percent. Accordingly, item (2) may be excluded from subpart F pursuant to an election under paragraph (d)(5) of this section, since it is subject to foreign tax at an effective rate that is greater than 30.6 percent (90 percent of 34 percent). However, it remains high withholding tax interest when included.

*Example 2.* The facts are the same as in Example 1, except that CFC's country of operation imposes a tax of \$50 with respect to CFC's dividend income. The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) \$100 of FPHC/high withholding tax interest income, and (2) \$50 of FPHC/passive income (net of the \$50 foreign tax). Both items are taxed at

an effective rate greater than 31.6 percent. Item 1: Foreign tax (\$50) divided by sum (\$150) of income item (\$100) plus creditable tax thereon (\$50) equals 33 percent. Item 2: Foreign tax (\$50) divided by sum (\$100) of income item (\$50) plus creditable tax thereon (\$50) equals 50 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either, both, or neither of items 1 and 2 from subpart F.

*Example 3.* The facts are the same as in Example 1, except that the \$100 of portfolio dividend income is subject to a third-country withholding tax of \$50, and the \$150 of interest income is from sources within CFC's country of operation, is subject to a \$10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (d)(4)(ii)(A) of this section they constitute separate items of income pursuant to the application of the grouping rules of § 1.904-4(c). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) \$50 (net of tax) of FPHC/non-country of operation/greater than 15 percent withholding tax income; and (2) \$140 (net of \$10 tax) of FPHC/country of operation income. Item 1 is taxed at an effective rate greater than 30.6 percent, but Item 2 is not. Item 1: Foreign tax (\$50) divided by sum (\$100) of income item (\$50) plus creditable tax thereon (\$50) equals 50 percent. Item 2: Foreign tax (\$10) divided by sum (\$150) of income item (\$140) plus creditable tax thereon (\$10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude Item 1 but not Item 2 from subpart F.

*Example 4.* The facts are the same as in Example 3, except that the \$150 of interest income is subject to an income tax of \$50 in CFC's country of operation. Accordingly, CFC has two items of income, as in Example 4, but both items are taxed at an effective rate greater than 30.6 percent. Item 1: Foreign tax (\$50) divided by sum (\$100) of income item (\$50) plus creditable tax thereon (\$50) equals 50 percent. Item 2: Foreign tax (\$50) divided by sum (\$150) if income item (\$100) plus creditable tax thereon (\$50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(ii)(B) of this section, CFC's shareholders must consistently elect or not elect to exclude from subpart F all items of FPHC income that are eligible to be excluded. Therefore, an election may be made to exclude both Item 1 and Item 2 from subpart F, or neither may be excluded.

(e) *Character of an item of income*—(1) *Substance of the transaction.* For purposes of section 954 and the regulations thereunder, items of income shall be characterized in accordance with the substance of the transaction, and not

in accordance with the designation applied by the parties to the transaction. For example, an amount received as “rent” which actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as “rent” but shall be characterized as income from the sale of property, royalties or income from services, respectively. Local law shall not be controlling in characterizing an item of income.

(2) *Separable character.* To the extent one of the definitional provisions of section 953 or 954 describes a portion of the income or gain derived from a transaction, that portion of income or gain is so characterized. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing and selling personal property, receives interest (including imputed interest and market discount) on an account receivable arising from a sale, a portion of the income derived from the transaction by the controlled foreign corporation will be interest, and another portion will be gain (or loss) from the sale of personal property. If the sale is denominated in a currency other than a functional currency as defined in section 985 and the regulations thereunder, the controlled foreign corporation may have additional income in the form of foreign currency gain as defined in section 988.

(3) *Predominant character.* The portion of income derived from a transaction that meets the definition of foreign personal holding company income is always separately determinable, and thus must always be segregated from other income and separately classified under paragraph (2) of this paragraph (e). However, the portion of income derived from a transaction that would meet a particular definitional provision under section 954 or 953 and the regulations thereunder (other than the definition of foreign personal holding company income) in unusual circumstances may be indeterminable. If such portion is indeterminable, it must be classified in accordance with the predominant character of the transaction. For example, if a controlled

foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction, and the portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise indeterminable, then the classification of income from the transaction shall be made in accordance with the predominant character of the particular integrated arrangement.

(4) *Coordination of categories of gross foreign base company income or gross insurance income.* The definitions of gross foreign base company income and gross insurance income are limited by the following rules (to be applied in numerical order):

(i) If an item of income is included in subpart F income under section 952(a)(1) and the regulations thereunder as insurance income, it is by definition excluded from any other category of subpart F income.

(ii) If an item of income is included in the foreign base company oil related income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivision (i) of this paragraph (e)(4).

(iii) If an item of income is included in the foreign base company shipping income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivisions (i) and (ii) of this paragraph (e)(4).

(iv) If an item of income is included in foreign personal holding company income of a controlled foreign corporation, it is by definition not included in any other category of foreign base company income, other than as provided in subdivisions (i), (ii), and (iii) of this paragraph (e)(4).

An item of income shall not be excluded from the definition of a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in the general definition of another category of gross foreign base company income or gross insurance income, if the item of income is excluded from that other category by a more

specific provision of section 953 or 954 and the regulations thereunder. For example, income derived from a commodity transaction that is excluded from foreign personal holding company income under §1.954-2(f) as income from qualified active sales may be included in gross foreign base company income if it also meets the definition of foreign base company sales income. See §1.954-2(a)(2) for the coordination of overlapping categories within the definition of foreign personal holding company income.

[T.D. 8216, 53 FR 27492, July 21, 1988. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

**§4.954-2 Foreign personal holding company income; taxable years beginning after December 31, 1986.**

(a) *Computation of foreign personal holding company income—(1) In general.* Foreign personal holding company income consists of the following categories of income:

(i) Dividends, interest, rents, royalties, and annuities as defined in paragraph (b) of this section;

(ii) Gain from certain property transactions as defined in paragraph (e) of this section;

(iii) Gain from commodities transactions as defined in paragraph (f) of this section;

(iv) Foreign currency gain as defined in paragraph (g) of this section; and

(v) Income equivalent to interest as defined in paragraph (h) of this section. Paragraph (a)(3) of this section provides rules for determining the use or purpose for which property is held, if a change in use or purpose would affect the computation of foreign personal holding company income under paragraphs (e), (f), and (g) of this section. Paragraphs (c) and (d) of this section provide rules for determining certain rents and royalties that are excluded from foreign personal holding company income under paragraph (b) of this section.

(2) *Coordination of overlapping definitions.* If a particular portion of income from a transaction in substance falls within more than one of the definitional rules of section 954(c) and this section, its character is determined under the rules of subdivision (i)